

Office of Chief Counsel  
Internal Revenue Service

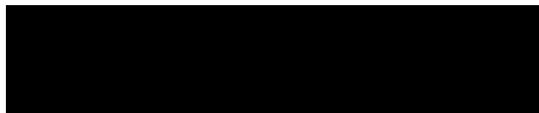
**memorandum**

CC:WR:SCA:SD:TL-N-7315-99

YMPeters

date: FEB 28 2000

to:



from: Associate District Counsel, Southern California District, San Diego

subject: [REDACTED], EIN [REDACTED], Tax year: [REDACTED]

Allocation of Research and Development Expenditures to FSC

**DISCLOSURE LIMITATIONS**

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*This advice is not binding on the Internal Revenue Service and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.*

**ISSUE**

Whether the taxpayer is permitted to allocate all research and development expenditures to domestic income and none to FSC income, where the same products are offered for sale domestically and internationally and records are not maintained to support a specific allocation along product lines.

**CONCLUSION**

The taxpayer is not permitted to allocate all research and development expenditures solely to domestic income. It has not provided sufficient records to establish that the expenditures were solely related to domestic income. It does not maintain records so as to determine whether the research expenditures did or did not lead to successful products. In

addition, all of its products fall within the same SIC. Therefore, the taxpayer's research and development expenditures should be allocated to FSC income based on the SIC system.

### FACTS

*Our advice is contingent on the accuracy of the information that the Internal Revenue Service has supplied. If any information is uncovered that is inconsistent with the facts recited in this memorandum, you should not rely on this memorandum, and you should seek further advice from this office.*

██████████ develops, produces and markets ██████████ products which enhance the efficiency and effectiveness of ██████████ worldwide. For example, ██████████ produces ██████████. ██████████ Its products are manufactured in the United States. All products are offered for sale domestically and internationally. The products sold internationally are shipped, in bulk, to distributors. The distributors prepare final packaging for some products and for some, a country-appropriate power supply is provided. In all other respects the products sold domestically are identical to the products sold internationally.

██████████, the taxpayer, is the parent corporation of ██████████. ██████████ is also the ██████████% owner of ██████████. ██████████ is the sole supplier of products to ██████████. ██████████ handles all the foreign sales of products manufactured by ██████████. It is located in the ██████████. ██████████ is a commission FSC.

In order to develop its products, ██████████ has a research and development department which performs various research and development functions. Some of its activities, such as general use equipment and supplies, benefit all product development. Other research and development activities, such as ██████████, ██████████, ██████████, ██████████, ██████████ and ██████████ relate to particular processes. All of the products fall within SIC ██████████. Once research results in a viable product, the research and development costs are captured in the production department and deducted pursuant to I.R.C. § 174. Viable products appear in the taxpayer's catalog. Identical catalogs are distributed domestically and internationally.

██████████ and ██████████ do not maintain a comprehensive list of products they have attempted to develop or the ultimate outcome of that attempt. ██████████ cannot make a distinction as to which research and development expenditures pertain to domestic sales and which research and development pertain to international sales. Nor can it distinguish which research and development expenses resulted in successful products and which did not result in a saleable product, even though such costs are deducted through the production department. ██████████ agrees that research and development expenditures of prior years may have resulted in products which are currently exported because research and development is a continual process for all of its products.

In [REDACTED]'s foreign trade gross receipts (FSC gross income) was [REDACTED] percent of total gross receipts. On its [REDACTED] return, [REDACTED] allocated [REDACTED] percent of total research and development expenditures to [REDACTED]. To determine [REDACTED] taxable income, [REDACTED] used the combined taxable income (CTI) method. During the audit, [REDACTED] asserted that it should be permitted to change to [REDACTED] the amount of research and development expenditures allocated to [REDACTED]. The taxpayer argues, based on St. Jude Medical, Inc. v. Commissioner, 34 F.3d 1394 (9<sup>th</sup> Cir. 1994), *nonacq.*, 1995-2 C.B. 1, 1999-52 I.R.B.763 and The Boeing Co. et.al. v. U.S., No. C96-1990C, 1998 U.S. Dist. LEXIS 16212, (W.D. Wash. Sept. 10, 1998), *appeal docketed*, No. C96-1990C (9<sup>th</sup> Cir. August 1999), that the research and development expenditures are non-allocable general and administrative expenditures and therefore should be allocated entirely to its domestic sales.

### DISCUSSION

The Service, does not follow the reasoning or conclusions of St. Jude Medical, 34 F.3d 1394 or Boeing, 1998 U.S. Dist. LEXIS 16212. See AOC/CC-1999-005. These cases, however, are distinguishable from [REDACTED] on the facts. Although this memo discusses St. Jude Medical and Boeing it should in no way be surmised that this memo endorses the reasoning or conclusions of these cases.

In St. Jude Medical, 34 F.2d at 1402, the 8<sup>th</sup> Circuit Court of Appeals held that the taxpayer was not required to allocate research and development expenditures of unsuccessful product lines to successful product lines. In Boeing, 1998 U.S. Dist. LEXIS 16212 at \*5, the District Court for the Western District of Washington State held that research and development costs may be allocated on a product basis, as opposed to allocated to a broader classification of products as discussed in Treasury Regulation § 1.861-8. As a result, research and development expenditures which did not lead to product sales during a taxable period would still be allocated to that product line. These expenditures would not be allocated to other product sales or to product sales from that product line made in a later taxable period. The Boeing court, in reliance on St. Jude Medical, held that Treasury Regulation § 1.861-8(e)(3) was invalid as applied by the Service to calculate FSC income.<sup>1</sup> Boeing, 1998 U.S. Dist. LEXIS 16212 at \*7.

[REDACTED] is different from the taxpayers in St. Jude Medical and Boeing. In those cases the taxpayers kept distinct records for each product line and performed research specific to a particular product or product line. They maintained records of whether the research and development resulted in successful or unsuccessful products.

[REDACTED] and [REDACTED], in contrast, do not maintain such comprehensive records of their

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<sup>1</sup> This provision has been renumbered, effective January 1, 1996, as Treasury Regulation § 1.861-17. It has also been changed to allowing narrower three-digit SIC product classification, as opposed to two-digit SIC product classification, for purposes of allocating research and development expenditures. T.D. 8646, I.R.B. 1996-8.

research. All of [REDACTED]'s products fall within SIC [REDACTED]. Once research results in a viable product, the costs of the research for that product are charged to production and the product is offered for sale. All products are offered for sale domestically and internationally. [REDACTED] however, does not maintain records showing whether expenditures did or did not result in successful products. There is no comprehensive annual report of projects and their status.

The purpose of the FSC provisions is to create a tax incentive for the export of goods produced in the United States. Boeing, 1998 U.S. Dist. LEXIS 16212 at \*8. The tax benefits accorded to a FSC is an exemption from the U.S. corporate income tax for a portion of its export-related income. I.R.C. § 923(a). Export-related income can be calculated using administrative intercompany pricing rules. Pursuant to the intercompany pricing rules, the determination of exempt income is based on foreign trade gross receipts less expenses. I.R.C. §§ 924 and 925. [REDACTED] uses the combined taxable income method (CTI) to calculate FSC income. I.R.C. § 925(a)(2); Treas. Reg. § 1.925(a)-1T(d)(2). Using this method, expenses deducted from foreign trade gross receipts are from three categories (1) cost of goods sold; (2) costs "definitely related" to export property and (3) a ratable portion of costs that are "not definitely related to a class of gross income, in a manner consistent with Treasury Regulation § 1.861-8."<sup>2</sup> Treas. Reg. § 1.925-1T(c)(6)(iii)(D); see Treas. Reg. § 1.925-1T(d)(2)(iii).

Treasury Regulation § 1.925-1T(c)(8), states that a taxpayer may choose to group transactions as to product or product line so long as such grouping conforms to industry standards or the Standard Industrial Classification (SIC) system. General Dynamics Corp. v. Commissioner, 108 T.C. 107 (1997) confirms the application of these rules. Where research and experimentation is not clearly identified within any product category, it will be considered conducted with respect to all taxpayer's product categories. Treas. Reg. § 1.861-17(a)(2)(i). Here, [REDACTED] stated that all of its products fall within SIC [REDACTED]. Therefore all of its research and experimentation expenditures for its products will be attributed to that same product category.

[REDACTED] argues that its research and development expenditures are "non-allocable" expenses. "Non-allocable" expenses are expenditures not related to any export activity. "Non-allocable" expenses are not subtracted from foreign trade gross receipts when calculating FSC income. Treas. Reg. § 1.925-1T(c)(6)(iii)(D); Treas. Reg. § 1.925-1T(d)(2)(iii). [REDACTED] failed to provide evidence that any of its research and development expenditures were related solely to domestic activities or sales. Instead, it stated that it does not maintain such documentation and does not, in fact, know the specifics of its research and development expenditures in relation to domestic or international product sales.

Since [REDACTED] does not maintain records so as to determine whether its research expenditures led to a successful product, St Jude Medical and Boeing do not apply to this case.

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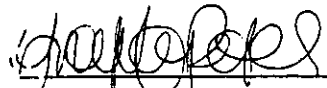
<sup>2</sup> As discussed in footnote 1, the applicable provision beginning January 1, 1996 is Treasury Regulation § 1.861-17.

Further, all of [REDACTED]'s products fall within the SIC [REDACTED] and all products were offered for sale internationally and domestically. Therefore, [REDACTED]'s research and development expenditures are allocable to FSC income according to the SIC system pursuant to I.R.C. § 1.861-17.

If you have any questions or need further assistance, please contact Yvonne Peters at (619) 557-6014.

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